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No. 87-1020

In the Supreme Court of the United States

OCTOBER TERM, 1987

PAUL S. DAVIS, APPELLANT,

v.

MICHIGAN DEPARTMENT OF TREASURY

ON APPEAL FROM THE COURT OF APPEALS OF MICHIGAN

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether the doctrine of intergovernmental tax immunity, as embodied in 4 U.S.C. 111, prevents the State of Michigan from taxing the retirement benefits of former federal employees while exempting from taxation retirement benefits paid by the State and its political subdivisions.

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This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

1. The State of Michigan exempts from taxation all pensions and retirement benefits paid to retired employees of the State of Michigan and its political subdivisions. Pensions and retirement benefits received from all other sources, including federal retirement benefits, are deductible only up to $7,500 for a single return and $10,000 for a joint return. See Mich. Comp. Laws Ann. § 206.30(1)(h) (West 1986 & Supp. 1988); Mich. Stat. Ann. § 7.557(130) (Callahan 1984).[1]

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[1] Section 7.557(130) provides in relevant part:

(1) "Taxable income" in the case of a person other than a corporation, an estate, or trust means adjusted gross income as

Appellant is a retired federal employee living in Michigan. After paying state income tax on his federal pension for a number of years, appellant filed a complaint in the Michigan Court of Claims seeking a refund. He alleged that the Michigan Income Tax Act discriminated in favor of state retirement benefits and against federal retirement benefits in violation of 4 U.S.C. 111.[2]

2. On cross-motions for summary judgment, the Michigan Court of Claims concluded in an oral opinion that the Michigan Income Tax Act did not violate Section

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defined in the internal revenue code subject to the following adjustments:

* * * * *

(h) Deduct to the extent included in adjusted gross income:

(i) Retirement or pension benefits received from a public retirement system of or created by an act of this state or a political subdivision of this state.

(ii) Any retirement or pension benefits received from a public retirement system of or created by another state or any of its political subdivisions if the income tax laws of the other state permit a similar deduction or exemption or a reciprocal deduction or exemption of a retirement or pension benefit received from a public retirement system of or created by this state or any of the political subdivisions of this state.

(iii) Retirement or pension benefits from any other retirement or pension system as follows:

(A) For a single return, the sum of not more than $7,500.00.

(B) For a joint return, the sum of not more than $10,000.00.

[2] Section 111 provides in pertinent part:

The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States * * * by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

111 because a retired federal civil servant is not currently an "officer or employee of the United States" within the meaning of that provision (J.S. App. A10-A11). The Michigan Court of Appeals affirmed (*id.* at A1-A8). The court agreed with the Court of Claims that someone who is not currently working for hire is not an "employee." Section 111, the court therefore concluded (J.S. App. A6), "has no application to [appellant], since [appellant] cannot be considered an employee within the meaning of that act."

The court of appeals further concluded that the Michigan Income Tax Act did not violate equal protection because the favorable treatment afforded to state retirees "bear[s] a rational relationship to a legitimate state end" (J.S. App. A6-A7). "In our opinion," the court stated (*id.* at A7), "the attracting and retaining of qualified employees is a legitimate state objective which is rationally achieved by a retirement plan offering economic inducements" such as "tax exempt status for their retirement benefits." The court justified the discrimination against similarly-situated federal employees by noting (*ibid.*) that "[t]he State of Michigan, as an employer, owes a special responsibility to its employees, which it does not owe to federal employees." Appellant's application for leave to appeal to the Supreme Court of the State of Michigan was denied (*id.* at A9).

DISCUSSION

Section 111, by its plain terms, forbids discriminatory taxation of a retired federal employee who, through his pension, is still receiving "compensation for personal services as an officer or employee of the United States." If construed the same way as the nondiscrimination principle derived from the doctrine of intergovernmental tax im-

munity, Section 111 would appear to preclude a State from treating its own former employees more favorably for income tax purposes than former federal employees, absent a showing of significant differences between the two classes. Neither the courts below, nor the appellees have identified any such differences.

1. The Michigan court of appeals erred in concluding that appellant does not fall within the protection of Section 111. The court stated that as used in other contexts the term "employee" embraces only those who currently work for "hire" and that "a retired federal civil service employee is not to be considered an employee for civil service purposes." J.S. App. A4-A5. That is true (see, *e.g.*, *Chemical Workers* v. *Pittsburgh Glass*, 404 U.S. 157 (1971); *Lancellotti* v. *OPM*, 704 F.2d 91, 95 (3d Cir. 1983)); but it is also irrelevant. By its terms, Section 111 applies not just to the taxation of current employees of the United States, but to "the taxation of pay or compensation for personal service as an officer or employee of the United States." Appellant's pension is clearly compensation, albeit deferred compensation, "for" his years of "service as an * * * employee of the United States." See *e.g.*, *Zucker* v. *United States*, 758 F.2d 637, 639 (Fed. Cir.), cert. denied, 474 U.S. 842 (1985); *Kizas* v. *Webster*, 707 F.2d 524, 535-536 (D.C. Cir. 1983), cert. denied, 464 U.S. 1042 (1984); *Clark* v. *United States*, 691 F.2d 837, 842 (7th Cir. 1982). Appellant's pension therefore falls within the scope of Section 111. It follows that if the tax imposed by Michigan on that pension "discriminates" against federal retirees and in favor of state retirees based solely on "the source of the pay or compensation" (4 U.S.C. 111) then the Michigan tax is invalid.

2. Section 111 merely restates, in the context of taxation of compensation of federal employees by the States, the general constitutional rule requiring nondiscrimination in taxation of those dealing with the federal government. That rule, as applied to state taxation of federal payments to individuals, derives from the Supremacy Clause (Art. VI, Cl. 2). See *South Carolina* v. *Baker*, No. 94, Orig. (Apr. 20, 1988), slip op. 12 n.10. This Court's decisions construing the nondiscrimination principle in the context of intergovernmental tax immunities strongly suggest that the Michigan Income Tax Act "discriminates" against federal retirees within the meaning of 4 U.S.C. 111.

Under the doctrine of intergovernmental tax immunity, "States may not impose taxes directly on the Federal Government, nor may they impose taxes the legal incidence of which falls on the Federal Government." *United States* v. *County of Fresno*, 429 U.S. 452, 459 (1977) (footnote omitted). For many years this doctrine was interpreted broadly to prohibit state taxation of the salaries of officers and employees of the United States (*Dobbins* v. *Commissioners of Erie County*, 41 U.S. (16 Pet.) 435 (1842)) as well as federal taxation of the salaries of state officials. *Collector* v. *Day*, 78 U.S. (11 Wall.) 113 (1870). In *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938), however, this Court implicitly overruled *Day* by permitting the imposition of a federal income tax on employees of the New York Port authority. One year later, in *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. 466, 480 (1939), the Court expressly overruled *Dobbins*, declaring that "[t]he theory * * * that a tax on income is legally or economically a tax on its source, is no longer tenable." Since *Graves*, "[s]ubsequent cases have consistently reaffirmed the principle that a nondiscriminatory tax collected from private parties contracting with another government is constitutional" (*South Carolina* v. *Baker*, slip op. 15).

Congressional consideration and enactment of the predecessor of Section 111 responded to, and occurred during, the period of judicial abrogation of the *Day-Dobbins* doctrine. Following the Court's decision in

Gerhardt, Congress believed there was no longer any constitutional impediment to federal taxation of the income of state employees. In view of this development, Congress concluded that, in fairness, federal officers and employees should no longer remain immune from nondiscriminatory state taxation. Section 4 of the Public Salary Tax Act of 1939 (1939 Tax Act), ch. 59, 53 Stat. 574, the predecessor of Section 111, was designed to waive federal immunity to permit such taxation. See H.R. Rep. 25, 76th Cong., 1st Sess. (1939); S. Rep. 112, 76th Cong., 1st Sess. (1939).

Shortly before the 1939 Tax Act was approved by Congress, however, this Court decided *Graves*. Accordingly, the government's "consent[] to the taxation of pay or compensation for personal service as an officer or employee of the United States" in Section 111 was, in effect, merely a codification of the intervening decision overruling *Dobbins*. Nonetheless, in conditioning state taxation of federal employees' compensation on the State's "not discriminat[ing] against the officer or employee because of the source of the pay or compensation," Congress anticipated "[t]he nondiscrimination principle at the heart of modern intergovernmental tax immunity caselaw." *South Carolina* v. *Baker*, slip op. 19 n.14.[3]

3. Under the nondiscrimination principle in the law of intergovernmental tax immunity, a tax is invalid, even

[3] Congress may by legislation expand federal tax immunity beyond the confines of the constitutional doctrine. See *Baker*, slip op. 12 n.10 ("The Federal Government * * * possesses the power to enact statutes immunizing those with whom it deals from state taxation even if intergovernmental tax immunity doctrine would not otherwise confer an immunity."). Plainly, Section 111 was not designed to extend federal tax immunity. Nor, on the other hand, is there anything in the language or history of Section 111 to suggest that Congress intended further to limit federal tax immunity by drawing a new distinction between working federal employees and federal retirees when it authorized nondiscriminatory taxation.

if it is not imposed directly on the United States, " 'if it operates so as to discriminate against the Government or those with whom it deals.' " *Moses Lake Homes, Inc.* v. *Grant County*, 365 U.S. 744, 751 (1961) (quoting *United States* v. *City of Detroit*, 355 U.S. 466, 473 (1957)). See *South Carolina* v. *Baker*, slip op. 16-17; *Phillips Chemical Co.* v. *Dumas Independent School Dist.*, 361 U.S. 376, 387 (1960). Clearly, the burden of the tax in question here falls on those with whom the United States deals. Appellant's pension is subject to taxation solely because it is paid by the federal government rather than by the State or one of its subdivisions. It would appear, therefore, that the Michigan Income Tax Act operates in a discriminatory fashion in imposing a tax upon the retirement benefits of a former federal employee but not imposing it in similar circumstances upon the retirement benefits of former state employees. The principle of nondiscrimination precludes a State from imposing a tax on federal retirees if "it treats someone else better than it treats them." *Washington* v. *United States*, 460 U.S. 536, 545 (1983) (footnote omitted).

4. Appellees stress (Mot. to Dis. or Aff. 4) that federal retirees have not been singled out for a tax imposed on them alone. Rather, all pensions that are not paid by the State or one of its political subdivisions are treated alike. This Court's decisions, however, have rejected the notion that a state may avoid the charge of discriminatory taxation by treating the federal government or those with whom it deals the same as other private entities.

In *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. 392 (1983), Tennessee imposed a tax on the net earnings of banks doing business within the State, and defined net earnings to include income from obligations of the United States and its instrumentalities but to exclude interest earned on the obligations of Tennessee and its political

subdivisions. Although Tennessee treated income from obligations of the United States the same as income from private obligations, the tax was nonetheless declared invalid. "It is clear," the Court noted (*id.* at 398-399 (footnote omitted)), "that under the principles established in our previous cases, the Tennessee bank tax cannot be characterized as nondiscriminatory * * *. Tennessee discriminates in favor of securities issued by Tennessee and its political subdivisions and against federal obligations. The State does so by including in the tax base income from federal obligations while excluding income from otherwise comparable state and local obligations. We conclude, therefore, that the Tennessee bank tax impermissibly discriminates against the Federal Government and those with whom it deals."[4]

Similarly, in *Phillips Chemical Co.* v. *Dumas Independent School Dist., supra*, the State of Texas imposed a lesser tax burden on lessees of State property than it imposed on lessees of federal property. The Court held that the discriminatory tax was invalid despite the fact that "there appears to be no discrimination between the [federal] Government's lessees and lessees of private property" (361 U.S. at 381). The crucial point, the Court noted

[4] The Michigan court of appeals (J.S. App. A7-A8) sought to distinguish *Memphis Bank* on the grounds that Tennessee's tax was rendered invalid by a specific federal statute, 31 U.S.C. (1976 ed.) 742, which prohibits all but nondiscriminatory franchise or non-property taxes on federal obligations. See also Mot. to Dis. or Aff. 14-18. In analyzing Section 742, however, the Court stated that it viewed that statute "as principally a restatement of the constitutional rule" (459 U.S. at 397) and proceeded to scrutinize the Tennessee tax under the general doctrine of intergovernmental tax immunity (*id.* at 397-398). *Memphis Bank* is therefore directly on point.

(*id.* at 382), was that the federal lessee "would not be taxed at all if its lessor were the State or one of its political subdivisions instead of the Federal Government. The discrimination against the United States and its lessee seems apparent." "[I]t does not seem too much," the Court concluded (*id.* at 385), "to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself."

Under *Memphis Bank* and *Phillips Chemical Co.,* it would appear that the State of Michigan is discriminating in favor of pensions granted by the State and its political subdivisions and against federal pensions. "The State does so by including in the tax base income from federal [pensions] while excluding income from otherwise comparable state and local [pensions]" (*Memphis Bank*, 459 U.S. at 398 (footnote omitted)). The federal pensioner "would not be taxed at all if its [former employer] were the State or one of its political subdivisions instead of the Federal Government. The discrimination against the United States and its [retirees] seems apparent." *Phillips Chemical Co.,* 361 U.S. at 382.

5. The Michigan court of appeals, without denying that the Michigan Income Tax Act discriminates against former federal employees, sought to justify that discrimination under traditional equal protection principles on the ground that the statutory classification "bear[s] a rational relationship to [the] legitimate state end * * * [of] attracting and retaining * * * qualified employees" (J.S. App. A6-A7). But this Court has already made it clear that ordinary equal protection principles "are not necessarily controlling where problems of intergovernmental tax immunity are involved" (*Phillips Chemical Co.,* 361 U.S. at 385). General policy considerations are not sufficient to justify discriminatory taxation against

those who deal with the federal government. "The imposition of a heavier tax burden on [those who deal with the federal government] than is imposed on [those who deal with the State government] must be justified by significant differences between the two classes" (*id.* at 383). The court of appeals made no attempt to justify the differential treatment of state and federal retirees under this exacting standard.

The fact that the discrimination at issue here gives the State a competitive edge does not distinguish it from any other special tax benefit given to those who deal with the State rather than the federal government and does not justify the discrimination. In *Phillips Chemical Co.*, 361 U.S. at 384, the Court expressly rejected a similar justification proffered by the State that favorable tax treatment for its lessees would "facilitate the leasing of its own land." See *United States* v. *City of Manassas*, 830 F.2d 530, 534 (4th Cir. 1987) (the only "justification" that would support a statute discriminating against those who deal with the United States is "a showing that the two classes of users, from federal and state sources, are not similarly situated, so that in essence there is no discrimination"), aff'd, No. 87-1117 (Apr. 25, 1988).

Nor can the exemption of state pension benefits from state taxation be justified on the ground that the State could accomplish the same result by increasing the amount of benefits paid to retirees. If the State increased pension benefits, this in turn would increase the federal tax liability of state retirees. Thus, in order to confer the same monetary advantage upon state retirees, the State would have to pay out more in additional benefits than it foregoes in lost tax receipts.[5] In *Phillips Chemical Co.*, the

[5] The differential impact in terms of federal taxation is reduced to some extent by the fact that the option of increasing pension benefits would yield not only higher federal taxes but also higher state taxes,

Court rejected an analogous contention to the effect that differential treatment of lessees of state property could be justified because "the State can collect in rent what it loses in taxes from its own lessees" (361 U.S. at 384).

In sum, contrary to the decision below, Section 111 applies to all persons receiving pay or compensation for personal services rendered to the United States, whether that pay or compensation is for current services or is deferred compensation for services performed in the past. And if the nondiscrimination provision of Section 111 is interpreted in light of this Court's intergovernmental tax immunity decisions, then a State may not treat its own former employees more favorably for income tax purposes than former federal employees, unless there are significant differences that justify treating these two classes of former employees unequally. Neither the lower courts nor appellees have advanced any distinction between state and federal retirees that would appear to qualify under this standard. The jurisdictional statement therefore presents a substantial federal question that ought to be resolved by this Court.[6]

which are generally deductible from income for purposes of determining federal tax liability. But because state income tax rates are invariably lower than federal income tax rates, the higher deduction would never completely offset the additional federal tax liability.

[6] Appellant has standing to challenge the Michigan Act, even though the State could respond in a number of ways to a judgment invalidating the differential treatment of former state and federal employees, including eliminating the special exemption for former employees of the State and its political subdivisions, as well as extending this exemption to former federal employees. See, e.g., *Heckler* v. *Mathews*, 465 U.S. 728, 737-740 (1984); *Orr* v. *Orr*, 440 U.S. 268, 271-273 (1979). As in cases claiming a denial of equal protection, the appropriate remedy here "is a *mandate* of equal treatment, a result that can be accomplished by withdrawal of benefits from the favored class as well as by extension of benefits to the excluded class." *Mathews*, 465 U.S. at 740 (emphasis in original).

CONCLUSION

Probable jurisdiction should be noted.

Respectfully submitted.

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